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Final curtain?

FRTB to constrict liquidity, trading

The Basel Committee's finalised fundamental review of the trading book (FRTB) marks another milestone in regulators' long and conflicted relationship with securitisation. While the final draft is less punitive than early versions suggested it might be (SCI 15 January), it is still set to limit market liquidity and trading activity.

"The final version of the FRTB has provided extra clarity to the market, but there is not much difference from earlier versions in terms of the mechanics. It provides an extra burden for banks and we have already seen those banks massively reduce their trading activities," says Werner Gothein, partner, BearingPoint.

He continues: "For credit risk, it looks like trading is becoming unattractive. On the one hand, the ECB is pushing ABS and on the other hand, it is making it very difficult."

The final version of FRTB reduces credit spread widening shocks to measure market risk across securitisation tranches, which will replace banks' existing approach to market risk. Securitisation capital requirements under the final framework will therefore be far lower than anticipated using the July 2015 assumptions, but will still be higher than current capital requirements.

"The final draft of the FRTB is still calling for a median increase in capital requirements of around 20%. That seems excessive, particularly considering the extent to which capital has already been increased since 2008," says Dan Castro, founder and president, Robust Advisors.

He notes that when the TRACE process was introduced for structured finance, the intention was to increase transparency, but the result was reduced liquidity. Because the market can see in black and white where paper has traded, the profits that can be made through trading have been squeezed and the incentive is much reduced.

Between TRACE, Basel 3 and FRTB, trading activity is being constricted from multiple angles, Castro suggests. The impact on liquidity is "inevitable" – and ignores the work banks have done over the last few years.

"The banks self-policed themselves as a result of the crisis. They have pulled back in many areas. That has already had an impact on liquidity, but now in addition banks are getting crushed with capital requirements and having to show everybody where things are trading," says Castro.

While the FRTB framework may be stricter than required, it also marks a move away from the use of internal models. Gothein believes this is a mistake.

"In the mid-1990s the philosophy of regulatory bodies was that people within the banks were best placed to assess those banks' risk. Therefore, they accepted internal models and were trusting in competent people, who knew what they were doing. Now, however, the risk calculation models defined by regulatory bodies tell you exactly what you have to do and you must follow a complex and expensive standardised approach," says Gothein.

He continues: "This new philosophy will make it difficult to run internal models because there is no cost advantage any more. But following only standardised approaches does not improve the effectiveness of risk analysis, leads to potential misallocation and a potential increase in systematic risk."

This also concerns Castro. He says: "You would think that internal models would be the most appropriate option because they are tailored, but instead they are being penalised. This just builds inefficiency into the market."

The fact that a market can be made safer by preventing trading does not mean it is working well. FRTB appears set to strongly disincentivise holding inventory.

However, in the longer term, the market may well adapt to the new regime. "Clever bankers will find ways to optimise their portfolio to make it not quite so painful, but in the meantime liquidity will suffer," Castro concludes.

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This article was published in Structured Credit Investor on 15 March 2016.